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PERSONAL INCOME TAX SYSTEM: ITS REFORM

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PERSONAL INCOME TAX SYSTEM: ITS REFORM

ISSUE DEFINITION

On 18 June 1987, the Honourable Michael Wilson, the Minister of Finance, presented to Parliament a White Paper on Tax Reform. Reform of the personal income tax was a major component of the package. Committees of the House of Commons and Senate issued reports on the White Paper. On 30 June 1988, the government introduced Bill C-139, an Act to amend the Income Tax Act. This bill, which contained many of the recommendations from the White Paper, received Royal Assent in September 1988.

It is understandable that changes to the personal tax system would be at the centre of tax reform. In 1985, the Canadian Institute of Public Opinion reported that 69% of Canadians surveyed believed that taxes were too high. And the tax most visible to the average Canadian is the personal income tax. Proposals for reform of this tax in Canada also received attention as a result of tax reform in the United States, where the tax base was broadened and the schedule of personal tax rates was simplified and drastically reduced.

BACKGROUND AND ANALYSIS

Personal income tax is popular with government because it provides a generous and relatively stable source of revenue, and is fairly easy to collect. In 1917, the Canadian government instituted the income tax as a temporary measure. Seventy years later, this tax is the largest single source of government revenue, representing over 40% of revenue to all levels of government. In 1987, personal income tax (federal and provincial) produced $95 billion in revenue, more than the next three most important sources of tax revenue (sales tax, profits tax

and property tax) combined. Federal personal income tax in 1987 produced about $54 billion or 54% of total federal revenue. One goal of the recent tax reform is a rebalancing of the sources of federal tax revenue by lowering the share of personal income tax and increasing the shares of corporate income tax and sales tax.

Since the end of the Second World War, however, and especially since the early 1970s, the personal income tax system has been used for more than the raising of revenue. The rate structure and the myriad of exemptions and deductions have also been used for social and economic goals, from redistributing income to promoting investment in Canadian companies. These social and economic goals have made the tax system so complicated that some question whether new tax changes would be counterproductive.

A. Attributes of a Tax System

In the 18 June 1987 White Paper, the Minister of Finance selected five broad objectives: fairness, competitiveness, simplicity, consistency and reliability. <u>Fairness</u>, <u>simplicity</u>, and <u>efficiency</u> (or "competitiveness" as it is called in the White Paper) are the three characteristics usually considered important to an ideal tax system. (Any tax system, ideal or not, is meant to raise revenue.) At first glance, of course, these three characteristics or guidelines seem irreproachable. But different people have different notions about what constitutes fairness, simplicity, efficiency - or any other attribute of an ideal system.

Fairness (also referred to as equity) has several dimensions. The two most often cited are horizontal equity and vertical equity. Horizontal equity requires individuals in similar economic circumstances to pay similar amounts of tax. Vertical equity requires individuals with higher incomes not to pay a smaller percentage of their income in taxes than those with lower incomes. In other words, the income tax system should be progressive - tax rates should increase with income levels. The problem is that people disagree about <u>how</u> progressive it should be.

The House of Commons Standing Committee on Finance and Economic Affairs examined the issue of simplicity in the tax system and issued its report *Tax Simplification* in June 1986. This pointed to problems in the current tax system, citing "a Tax Act that even experts

find confusing and a tax form for the average taxpayer that is daunting in length and complexity" (p. 1). The Committee's report proposed a straightforward approach to tax simplification: "People must be able to read and understand the *Income Tax Act*. Citizens must be able to read and understand the tax forms they are required to submit" (p. 11).

The last point is especially important, as the Canadian income tax system is based on voluntary compliance and self-assessment. Faced with complicated tax forms, citizens seek professional help in preparing these. Over a third of tax filers in 1985 (including 17% of those filing the "simple" T1 Special Form) used the services of tax preparers. Although it is obviously impossible to present precise figures, it is believed that complicated tax forms also lead to tax evasion and the growth of the so-called underground economy - both of which are of concern in Canada as they are throughout the world.

Efficiency probably has more dimensions and possible definitions than equity. To some, the tax system is efficient if it does not distort market decisions, especially those dealing with saving and investing. But the unfettered market allocates resources to maximize <u>private</u> returns, so others feel that the tax system is fairer when it is used consciously to accomplish <u>social</u> goals. Unfortunately, the social goals are often not well defined. In addition to social and private efficiency, there is what may be termed revenue efficiency - the minimizing of the costs of collecting an additional dollar of revenue. This last notion of efficiency is often overlooked while tax policymakers focus on social goals; in some tax changes it can cost more than a dollar to collect an additional dollar of revenue.

Even if everyone agreed about definitions, there would still be disagreements about the characteristics of the ideal tax system. An attempt to make the system fairer might make the system less efficient - increasing the progressivity of the tax rate schedule, for example, might curb some desirable investment. And juggling fairness and efficiency, as was attempted in budgets for so many years, produces a tax system that is far from simple.

B. The Canadian and U.S. Systems

Canada, because of its geographic and economic links with the United States, must pay close attention to tax changes in that country. But this does not mean that Canada should simply duplicate U.S. tax reform. (See G.S. Goldstein, "The American Tax Reform Act of 1986," Mini-Review 86-27E, Library of Parliament, Ottawa, 30 October 1986, for a discussion

of the tax reform in the U.S.) Tax systems in the two countries are similar, but not identical. The most important differences have to do with the position of the states and provinces in the respective systems.

In Canada, nine of the provinces (Quebec is the exception) and both territories tie their personal income tax to the federal system. Provincial taxes are raised as a surtax on the basic federal tax, so any change in the federal system automatically affects provincial taxes. For all provinces but Quebec, the federal government collects provincial income tax when it collects federal taxes. In the U.S., on the other hand, no state has its taxes collected by the federal government. In 1984, only four states used federal tax payable as a base for calculating their own income tax, and, of these four, one allowed its taxpayers to use that base as an option.

The importance of income tax to state revenue varies widely among the states. Several have no personal income tax, while eight rely on personal income tax as their largest source of revenue. On average in 1984, states raised 30% of their tax revenue from a personal income tax; the average for Canadian provinces in the same year was 36.6% of tax revenue, with a range from 17.4% (Alberta) to 50.2% (Quebec).

As a proportion of GNP, state personal income tax is much less important than provincial personal income tax. This can be seen from the following table:

Personal Income Tax as a Percentage of GNP, 1984 (fiscal year)

	Canada	U.S.
Federal	6.7	8.1
Provincial/state	5.1	1.8
Total	11.8	9.9

Source: D.B. Perry and J.L. Ballantyne, "Tax Reform in the United States and Canada: The Position of State and Provincial Governments," *Canadian Tax Journal*, Vol. 34, No. 4, July-August 1986, p. 917-928.

This table also shows that total personal income tax in the U.S. is less important than total personal income tax in Canada. The table does not, however, include social security contributions, which are much higher there than in this country (6.8% of GNP in 1984 for the U.S. to 3.7% of GNP in Canada).

In the U.S., the federal government could ignore the states in determining tax reform. The federal government in Canada will certainly not be able to ignore the provinces. Any change in tax rates or in the definition of taxable income by the federal government has automatic effects on provincial income taxes. Moreover, a change in the federal/provincial income tax structure will have repercussions on policy directed at other revenue sources.

C. Proposals for Change

1. Broadening the Tax Base

Base broadening is viewed by many as essential to the reform of both the personal and corporate income tax systems. It is generally accomplished by reducing personal exemptions, taxing previously exempt income, and eliminating or narrowing the scope of tax incentives which encourage certain activities.

In 1967, the Carter Commission proposed a broadened or comprehensive tax base which would consider the economic power of the taxpayer by including virtually all additions to wealth. The government responded to the Carter Commission's recommendations by issuing the 1969 White Paper entitled *Proposals for Tax Reform*. This document did not follow all of the Commission's recommendations, but did contain several measures designed to broaden the tax base. Among these were the inclusion in income of capital gains and various fringe benefits received by employees or by the owners of businesses, and the taxation of unemployment insurance benefits, fellowships, research grants and scholarships.

Public reaction to both the Carter Commission recommendations and the White Paper proposals was largely negative. A tax reform bill was passed in 1971, but it reflected the Carter Commission recommendations in only a limited manner and departed from many of the White Paper proposals. The bill did, however, broaden the personal income tax base to include, among other things: unemployment insurance benefits, scholarships (with a $500 annual exemption) and half of realized capital gains.

One of the stated goals of the 1981 Budget was to increase the fairness of the tax system. To this end, it proposed several base-broadening measures including the elimination of income-averaging annuity contracts and other income-averaging provisions, and the taxation of

certain employee benefits such as health services and dental plans and low interest or interest-free loans. The Budget also restricted deductions for interest expenses to the amount of annual investment income, disallowed the deduction of interest on money borrowed to purchase RRSPs, and repealed the capital gains reserve provisions. Intense lobbying and negative public response resulted in three separate amendments to the 1981 Budget proposals. The final product, legislated into effect in 1983, was a diluted version of these original proposals.

As previous attempts demonstrate, broadening the tax base can be difficult. Taxpayers are reluctant to give up any advantages received from previous budgets and associated tax measures. Furthermore, many tax incentives are the means that government has chosen to achieve certain valid economic and social objectives; it cannot automatically be assumed that they will be eliminated, even where the tax system is shown to be an inefficient method of program delivery.

The 1987 White Paper proposals to broaden the tax base involved the reduction or elimination of a number of deductions, including those dealing with investment income, employment expenses, films, multiple unit residential buildings (MURBs), meals and entertainment, and automobiles and home office costs. More specifically, the White Paper suggested abolishing the $500 employment expense deduction and the deduction for up to $1,000 of interest and dividend income and reducing the dividend tax credit. Further, it proposed that the lifetime exemption for capital gains (first introduced in 1985 and intended ultimately to reach $500,000) would be held at its 1987 level of $100,000 (except for farmers and some small businesses for which the capital gains exemption would be maintained at $500,000). In addition, the White Paper proposed an increase in the portion of capital gains included in taxable income.

2. Lowering Tax Rates

Lowering tax rates was an important component of tax reform in the United States. Such rate reductions complement measures to broaden the tax base as they can offset, in whole or in part, the effects of having larger amounts of income subject to tax.

Proponents of lower tax rates contend that they provide the impetus for increased economic activity, which, in the long run, will result in higher levels of tax revenue. High

rates, on the other hand, may adversely affect incentives to work and save and provide an inducement to participate in the underground economy. High tax rates might also lead to investment decisions based on the investor's current tax position and not on the investment's soundness or profitability.

The old federal personal income tax rate structure, as seen in Chart 1, was composed of progressive marginal rates in 10 rate brackets ranging from 6% to 34%. The Canadian and U.S. tax rate structures were similar. Both were progressive, with higher marginal tax rates associated with higher taxable incomes, and an almost identical top marginal tax rate. At income levels below about $120,000, however, marginal tax rates were consistently higher in Canada.

The new system in Canada involves three tax brackets, the lowest federal marginal tax rate being 17% of taxable income up to $27,500, the middle being 26% of taxable income between $27,501 and $55,000, and the highest being 29% of taxable income of $55,001 and over. The Department of Finance estimated that 66% of taxpayers would be in the 17% bracket, 29% in the 26% bracket, and 5% in the highest bracket. Chart 2 compares the new Canadian rates with post-tax reform rates in the United States. (The figure for Canada includes an adjustment for provincial income taxes, which, in most cases, are based on the federal income tax.)

3. Simplifying the Tax Structure

In June 1986, the House of Commons Standing Committee on Finance and Economic Affairs presented a report to the House of Commons on tax simplification. Recognizing that the goals of achieving tax equity and tax simplification might conflict, the Committee made several recommendations, including: (a) that no changes to the income tax system be made without first examining the impact of such changes on the complexity of the *Income Tax Act* and the tax forms, (b) that the current *Income Tax Act* be redrafted to make it readable, and (c) that the current package of exemptions deductions and special tax measures be reviewed to determine whether their benefits can be provided more simply, by some method outside the tax system or by adjusting tax rates or general exemptions.

More work remains to be done to simplify the tax system. As the House of Commons Standing Committee on Finance and Economic Affairs put it:

> It is disappointing for the Committee to draw the inevitable conclusion that the proposed tax reform has not successfully addressed the problem of simplifying the tax system. There are, of course, some elements of the proposed system that are less complex than corresponding elements in the current system. But new system is at least as complicated as the old. As many tax filers in the future as in the past will need the services of tax preparers, and corporations will face the same uncertainty in interpreting the Income Tax as they have in the recent past.
>
> In reviewing the White Paper, the Committee noted that the goals of efficiency and fairness were given priority over the goal of simplification. While the Committee agrees in theory with such a balancing of objectives, in practice the White Paper proposals would lead to needless complications.

4. Altering the Federal-Provincial Tax Collection Agreements

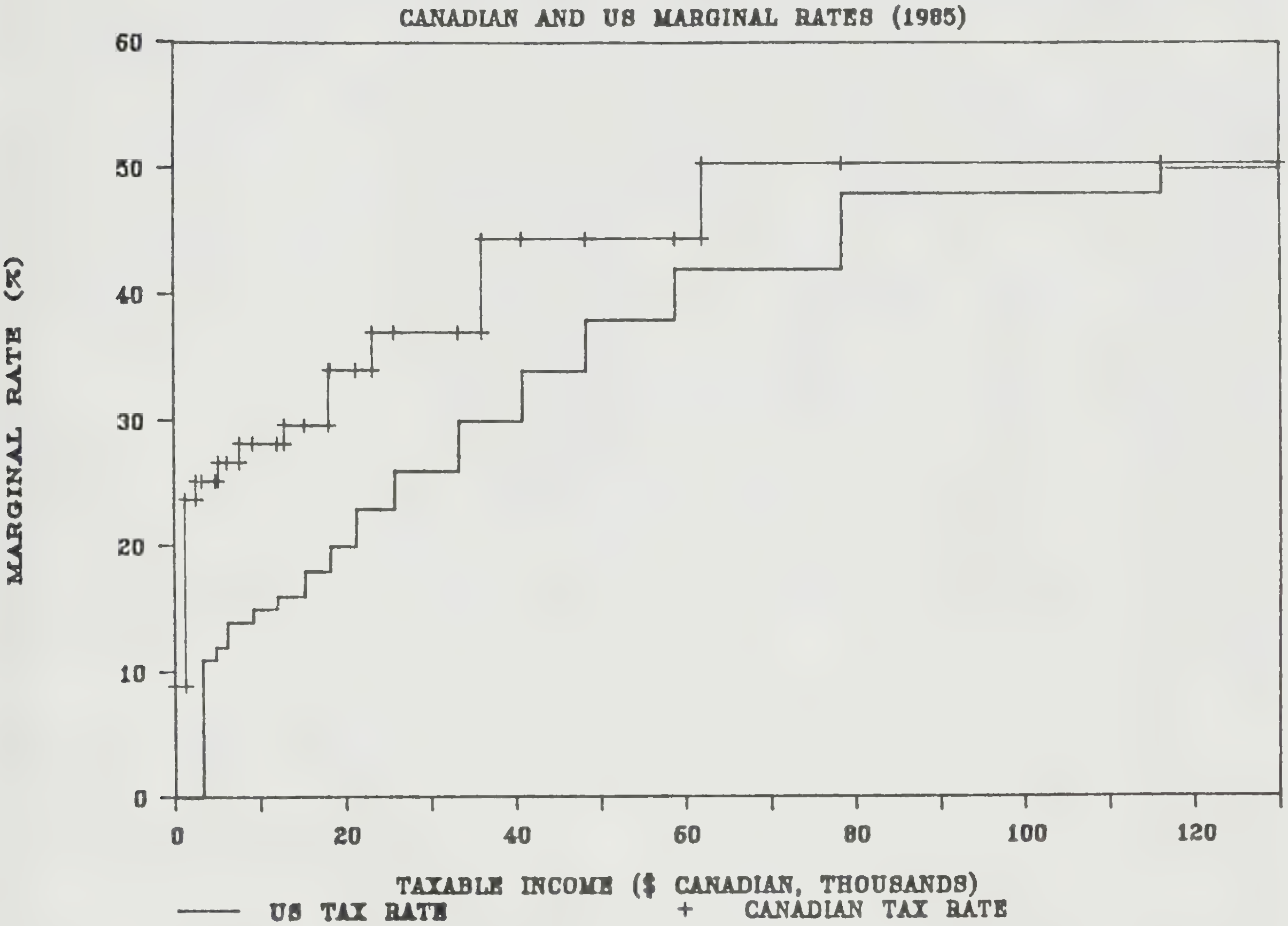
Under the tax collection agreements in place since 1962, the federal government administers personal income taxes on behalf of all provinces except Quebec. Some provinces, desiring greater flexibility to meet their social and economic objectives, have requested changes in the agreements. In line with these requests, on 25 June 1991 the Finance Minister released a discussion paper on Federal-Provincial Tax Collection Agreements.

Currently, the provincial personal income tax is based on the basic federal tax. Some provinces have suggested that the base be changed to the federally defined taxable income. With taxable income as a base, the provinces could establish their own tax rates and brackets, as well as defining their own non-refundable tax credits. The increased flexibility for the provinces, however, might lead to greater complexity for the tax filer. According to one estimate, such a change could theoretically require taxpayers to perform up to 20 additional calculations when preparing their returns.

The discussion paper seeks comments from individual Canadians, employers, associations and tax professionals on whether increased flexibility would come at the expense of simplicity, consistency and accountability of governments. As the press release from the Minister stated: "The paper is designed to elicit comments, not to provide proposals for change, nor to reach conclusions on the desirability of this increased provincial flexibility."

CHART 1

TAX RATES AS A FUNCTION OF INCOME

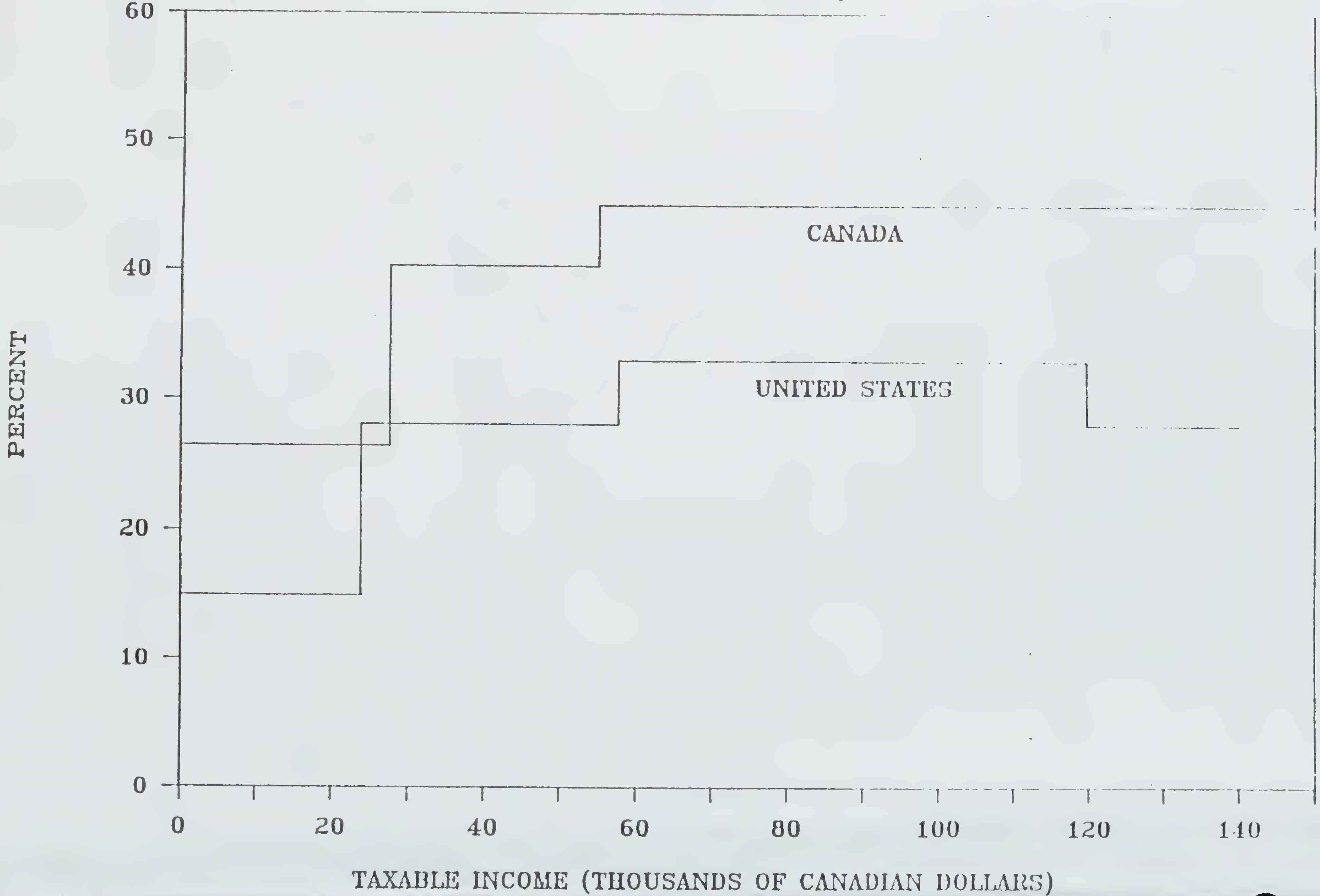


Source: U.S. and Canadian Tax Forms.

CHART 2

PERSONAL INCOME TAX RATES

CANADA & UNITED STATES, 1988



E. Conclusions

Tax reform in the United States has provided impetus to the movement to reform the Canadian income tax system. Important to any such reform would be changes to the personal income tax structure, particularly measures to broaden the tax base, reduce tax rates and simplify the system.

The main objectives of tax reform are fairness, simplicity and efficiency. Unfortunately, these are not always compatible. Measures designed to enhance the fairness of the system may not be economically efficient or simple. Tax concessions used to promote certain economic and social policy objectives may conflict with the equity objective by benefiting individuals with high incomes. Measures that promote efficiency may be neither fair nor simple.

As the reform process continues, legislators will be called upon to evaluate proposals with reference to these sometimes unavoidably conflicting objectives. Inevitably, compromises will have to be made. Those reforming the tax system must consider the relative importance of competing objectives and the extent to which one of these may be sacrificed to achieve another.

PARLIAMENTARY ACTION

A. White Paper on Tax Reform

In 1969, the government tabled before Parliament the White Paper, *Proposals for Tax Reform*. Among other things, the White Paper proposed that unemployment insurance, research grants, scholarships, bursaries, capital gains and various fringe benefits be included in the tax base. Other sources of income such as worker's compensation, strike pay and family allowances would not be taxed. Committees of both the House of Commons and the Senate held hearings on the White Paper and issued reports in 1970.

B. Bill C-259 (1971)

Passed in 1971, Bill C-259 implemented certain tax reform measures. Among these were measures to broaden the tax base by including in income unemployment insurance

benefits, scholarships (with a $500 annual exemption) and one-half of realized capital gains. The bill also implemented general averaging for all taxpayers and altered the tax rate structure.

C. November 1981 Budget

Stressing the principle of fairness, the 1981 Budget contained several base-broadening proposals. Among these measures were the inclusion in income of employee benefits such as free travel passes, dental plans, health services and low-interest or interest-free loans, the elimination of income-averaging annuity contracts (IAACs) and restricting the interest expense deduction to the amount of investment income earned in each year.

D. Bill C-139 (1983)

This bill implemented some of the tax reform proposals contained in the November 1981 Budget. (The budget proposals were altered three times before Bill C-139 was passed.) Measures to limit the deduction of interest costs to the amount of investment income and to tax employee benefits from health and dental plans were dropped. Other reform proposals were limited, or made subject to exceptions or conditions.

E. White Paper on Tax Reform

On 18 June 1987 the government tabled before Parliament the White Paper, *Tax Reform 1987*. A variety of changes to the corporate and personal income tax systems were proposed, and comprehensive sales tax reform was promised.

F. Bill C-139 (1988)

This bill implemented many of the tax reform proposals dealing with income tax found in the 1987 White Paper.

CHRONOLOGY

1967 - The Royal Commission on Taxation (Carter Commission) published its report which recommended comprehensive reform of the tax system.

1969 - Finance Minister E.J. Benson released a White Paper entitled *Proposals for Tax Reform.* This document set out the government's position on tax reform and outlined a number of reform proposals.

1970 - Public hearings into the White Paper were held by committees of both the House of Commons and the Senate. Reports by the Standing Senate Committee on Banking, Trade and Commerce and the House of Commons Standing Committee on Finance, Trade and Economic Affairs were issued in September and October 1970, respectively. For the most part, these reports were critical of the White Paper's proposals.

June 1971 - Bill C-259, proposing reforms to the tax structure, was introduced into the House of Commons. After numerous amendments and prolonged debate, it was passed in December 1971. Among other things, the tax bill provided for the taxation of one-half of capital gains, elimination of gift and estate taxes, reduction of corporate tax rates and modification of the dividend tax credit.

November 1981 - Finance Minister Allan MacEachen introduced a budget containing several reform proposals including: a temporary cap on partial indexation, repeal of the deduction for income averaging annuities, limits on the deductibility of investment costs, more stringent taxation of employee benefits, reforms to the manufacturers' sales tax, and the reduction of capital cost allowance write-offs. Public protest led to the introduction of several changes to these proposals.

October 1982 - Finance Minister Marc Lalonde announced several measures which substantially modified the reform proposals of the November 1981 budget.

30 March 1983 - The remaining MacEachen proposals embodied in Bill C-139 became law.

May 1985 - Finance Minister Michael Wilson released two discussion papers. *The Corporate Income Tax System, A Direction for Change* presented proposals for changes to the corporate tax system, including broadening the corporate tax base and lowering corporate tax rates. *A Minimum Tax for Canada* set out minimum tax structure proposals designed to ensure that high income individuals would pay a minimum level of income tax.

June 1986 - The House of Commons Standing Committee on Finance and Economic Affairs presented to the House of Commons a report entitled *Tax Simplification*. The report contained several proposals for simplifying the *Income Tax Act*.

1 October 1986 - In the Speech from the Throne, the government announced that it would introduce measures to lower tax rates, shift the tax burden away from personal income tax and create a simpler, more comprehensive tax system.

23 October 1986 - In a speech to the House of Commons, Finance Minister Michael Wilson announced that the government would initiate changes to the personal, corporate and sales tax systems.

18 February 1987 - In his budget speech, Finance Minister Michael Wilson announced that tax reform measures designed to simplify the tax system, limit special preferences and provide incentives through lower tax rates would be forthcoming.

18 June 1987 - Finance Minister Michael Wilson tabled a Government White Paper on tax reform in the House of Commons. Among other things, the White Paper contains proposals to reform the personal income tax system by lowering tax rates, reducing the number of tax brackets (from 10 to 3), decreasing the number of special preferences and using tax credits rather than exemptions.

16 November 1987 - The House of Commons Standing Committee on Finance and Economic Affairs issued its report on Stage One of the Government White Paper on Tax Reform.

30 June 1988 - The Government introduced Bill C-130, An Act to amend the Income Tax Act. This bill received Royal Assent in September 1988.

25 June 1991 - Finance Minister Don Mazankowski released a discussion paper on Federal-Provincial Tax Collection Agreements.

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